The Why and How of Capital Credits

ELECTRIC co-ops financed with REA loans differ from other kinds of co-ops in several important respects.

The typical agricultural co-op, for example, requires a relatively small capital investment in proportion to its annual business. Therefore, it is generally no great hardship for the members to put up a substantial part of the capital needed for the co-op business at the time it is organized. This means, in turn, that such a co-op needs to borrow relatively little money from outsiders and therefore has no heavy loan repayments to meet. If it finds at the end of the year that its charges for services to its patrons have been in excess of the cost of service, it can return most of that difference to them as patronage refunds, either immediately or at least within a few years.

An REA co-op, on the other hand, requires a very high capital investment per member. The annual business turnover amounts to only a fraction of the cost of its facilities. It is financed one hundred percent with an REA loan. In other words, the members have made no initial capital investment in their REA co-op aside from the small membership fee.

The REA program is based on the idea that the people who use the service of an REA co-op will eventually have full ownership of the co-op system. The only way this can be done is for these local people to put up the money needed to repay the REA loan. The REA repayment schedule is designed to make this as easy as possible. The rates charged by REA co-ops to take care of operating expenses and at the same time acquire local ownership are much lower than the rates these rural people would have to pay for service alone if there were no REA program—if they had been able to get service from commercial power companies.

Therefore, REA co-op members might consider themselves fortunate even if they did not get a personal stake in the net worth of the co-op as it builds up. They still would have a community service enterprise operated by the consumers for their joint benefit. But they are operating a co-op which is set up for the purpose of furnishing service at cost. This means that any payments made by a patron for electric service which are in excess of the cost of service must be expressly recognized as belonging to him. Otherwise he would not be receiving service at cost and the co-op would not be operating on a nonprofit basis.

An REA co-op cannot set its rates so that they will just cover actual cost of service. Its receipts from service bills must be adequate to take care of all of its cash obligations which include one item that is not a part of the cost of service, namely, repayments on the principal of the REA loan. A co-op must set its rates so that its receipts will be sufficiently greater than the actual cost of service to take care of that additional cash need.

It stands to reason that these excess receipts cannot be returned to the patrons immediately in the form of cash patronage refunds since they must be applied to reduction of the REA loan. In fact, such returns cannot begin to be made until the co-op has reached a financial condition which will permit it to do so without running the risk of not being able to meet all of its other cash obligations as they become due. In effect, therefore, any payments made by REA co-op patrons in excess of the cost of service are really capital investments by the patrons.

There are two somewhat different methods or plans for handling excess payments by patrons. Under the first, more commonly used in the past, these excess payments are treated as overpayments which are returned to the patrons as patronage refunds at the end of an operating period, usually at the end of the business year.

But if a co-op has need of these excess payments in order to pay off a loan, it must defer making patronage refunds. It can only credit each patron's account with the amount of his excess payment so there will be a record of what it owes him and will return to him if and when it is in a position to do so. In other words, it considers and uses this excess payment as though they were capital furnished by the patrons.

The second plan, the so-called "capital credits" plan, is better suited to co-ops which, like those financed by REA, have need of excess payments to pay off a loan. Where the capital credits plan is used, the co-op and the members expressly agree that excess payments needed for capital purposes are paid in as capital. Therefore, such amounts are credited to each patron on the co-op books as patronage capital.

Both plans are in keeping with co-operative principles and philosophy. But the second plan offers a number of advantages over the patronage refunds plan, as evidenced by the fact that it is increasingly being adopted in varying degrees by American co-ops

This article is to enable REA co-op directors, managers, and bookkeepers to understand the capital credits plan, think about its advantages, and discuss it among themselves before bringing it to the attention of the co-op members. Adoption of the plan should, however, be delayed until complete information is made available.

of different types. Its adoption by REA co-ops is especially timely now.

Most REA co-ops have not yet started to put into effect the bylaw provisions regarding patronage refunds and the setting up of various reserves. Instead, they have left the disposition of any annual surpluses for future action.

The capital credits plan is quite simple. It does not require the setting up of undivided reserves for various purposes, as is required by present REA co-op bylaws, before determining each patron's individual part of the excess receipts. No such individual reserves are needed under the capital credits plan because all excess receipts for electric service are capital which the co-op may use for any legitimate purpose. This means, in turn, that the capital credit of each patron (if there are excess receipts) will be greater under this plan that the amount of patronage refunds he could expect to receive under present bylaws provisions.

The plan provides that any receipts by the co-op for electric service which are in excess of the cost of furnishing the service are capital and are credited to all patrons (non-member patrons, if there are such, as well as member patrons) in proportion to what each has paid for electric service during the year to which the receipts apply. Since they are based on his patronage, this type of capital may properly be called patronage capital. The patronage capital supplied by each patron will be credited to him each year in his patronage capital account, and he will also be given a statement showing his capital credits for the year.

In years when the co-op has no such excess receipts, no capital can, of course, be credited to the patrons. If in any year the co-op has incurred an operating deficit, that deficit will also be shown on the books, but only in a lump sum. It will not be prorated and charged against the patrons' individual accounts. The net amount of the patronage capital shown on the balance sheet will, of course, be the difference between total patronage capital paid in and any deficits.

When a co-op becomes financially able, it can begin to retire, on a dollar-for-dollar basis, the capital supplied by patrons.

Retirement of patronage capital may take place in the same order in which it was supplied. In other words, all of the capital credits for the first year in which the co-op had excess receipts would be paid back before any payment is made on capital supplied in any following year. In this way, patronage capital is acquired and retired in rotation, assuring fair and equal treatment to all patrons.

It should be noted that under this plan an REA co-op cannot have any "income" or "surplus" from operating the electric distribution system, since all excess receipts for electric service are capital at the time of receipt and are so credited to the patrons at the end of the year.

Adoption of the capital credits plan would not affect in any way the exemption from Federal income tax accorded REA co-ops as nonprofit organizations. Of course, income taxes are not imposed on money furnished as capital to any business.

REA co-op bylaws do not now provide for this capital credits plan. Therefore, before any co-op can operate under this plan, it will have to amend its bylaws, and in some States even the articles of incorporation will have to be amended. REA is now making a study of the various State statutes and other pertinent factors so that it will be able to offer sound advice and assistance to all REA co-ops when they are considering adopting this highly desirable plan. The adoption of the plan will also require some minor changes in the co-op bookkeeping and accounting procedure on which REA is now preparing the needed explanation and sample forms.